

Regulatory Developments Affecting Project
Financings of Energy Projects

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I have been asked to address recent regulatory developments that have affected project financings of energy projects. This subject is always important because the energy industry in general operates in a complex regulatory environment, and energy project financings are inherently sensitive to regulatory changes. The non-recourse nature of project financings heightens the sensitivity of project sponsors and lenders to material changes in applicable regulations that affect the ability of projects to operate as projected or to market output. Such adverse regulatory developments can lead to covenant breaches, events of default, and bankruptcy or restructuring of project financings.

The breadth of this subject precludes a comprehensive analysis. Instead, I will focus on several of the more significant regulatory developments at the Federal Energy Regulatory Commission (“FERC”), the Environmental Protection Agency (“EPA”), and the Securities and Exchange Commission (“SEC”), respectively.¹ My principal theme is that in the wake of deregulation of the power industry throughout the United States, the 2001 California power crisis, the evolution of regional transmission pools, and the collateral damage to power companies and traders resulting from the Enron bankruptcy, we are in a period of heightened regulatory volatility that will complicate and burden energy project financings in the near term.

1. Market-Based Rate Authority

Power projects that are “Qualifying Facilities” under Public Utility Regulatory Policies Act are exempt from many provisions of the Federal Power Act, including the requirement that they have rates on file with the FERC. Exempt Wholesale Generators, or EWGs, on the other hand, are exempt from the Public Utility Holding Company Act, but not from the Federal Power Act. As a “public utility” under the Federal Power Act, any EWG that sells merchant power – in other words, many of the power projects that have been project financed recently – must have rates for the sale of power on file with the FERC. Generally, these are market-based rates. Until recently, the standard for obtaining such approval was a relatively straight-forward market-share test.² In part because of the perceived exercise of market power in California, the FERC announced in November of last year that it would abandon the “hub and spoke” share test and instead attempt to develop a new test considering factors such as (i) whether a particular generating facility is a strategic supplier of power and (ii) whether capacity from the generating facility is needed under peak load conditions.³ The uncertainty created by this new and evolving

¹ I would like to thank my Baker Botts colleagues Randy McManus, Bill Bumpers, Wendy Warren, Glenn Elliott, and Josh Frank for their helpful comments in preparing this paper.

² *AEP Power Marketing, Inc., et al*, 97 F.E.R.C. (CCH) ¶ 61,219, at 51,969 (2001).

³ *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 97 FERC (CCH) ¶ 61,220 (2001).

multi-faceted, subjective test will be an additional challenge to project developers of EWGs that will seek market-based rate authority.

2. Refunds

Apart from the issue of whether market-based rate authority will be granted, a more problematic regulatory development is the FERC's announced intention to condition market-based rate authorizations on vague behavioral standards regarding "anticompetitive" conduct, and to impose retroactive refunds if the FERC finds that market power was exercised by a generator.⁴ Specifically, the FERC has proposed attaching a refund condition to all market-based rate tariffs, which would be triggered if a generator engages in anti-competitive behavior or exercises market power.⁵ The uncertainty generated by this type of retrospective rewriting of rules and ordering of refunds may very well discourage developers, equity investors, and lenders from financing power projects with market-based rate authority. Goldman, Sachs & Co. – reflecting the views of many in the investment community – expressed these concerns in a January 3, 2002 comment letter in response to the November 2001 FERC Orders. In this letter, Goldman Sachs noted the potential for the FERC proposals to create an open-ended refund obligation for industry participants with market-based rate authority. The letter argues that the mere perception of such open-ended obligations by the investment community – whether or not they reflect the present intentions of the FERC – could turn away potential investment in the energy sector. Moreover, to the extent that the FERC's proposals require companies with power projects to restate earnings, the letter notes that the FERC's proposals could further weaken investor confidence in energy projects and publicly held owners of such projects.

To many market participants, it is ironic that the FERC under a conservative Republican Administration would show as little confidence in the free market as is reflected in the orders cited above – a lack of confidence far greater than anything witnessed during the Clinton administration. Nevertheless, the fact remains that the current leadership at the FERC appears poised to order refunds whenever it retrospectively determines, based on vague behavioral standards, that public utilities with market-based rate authority have engaged in anti-competitive behavior. Such regulatory risk will be problematic for the energy project finance industry.

3. Developing Regional Transmission Markets

Since early last year, the FERC has been actively working to consolidate the nation's electricity transmission systems, currently owned by many investor-owned utilities, into larger, regional transmission organizations, or RTOs. The FERC has expressed concern about the current state of the nation's transmission systems, most of which operate under varying market rules and tariffs that make it difficult to sell power between regions. In addition to the problems of trading across multiple systems, the balkanization of the nation's transmission systems also

⁴ *Id.*

⁵ *Id.*

inhibits investment in much-needed infrastructure upgrades.⁶ The FERC has thus been promoting RTOs as a vehicle for electricity generators to send power across long distances more easily and cheaper. This reflects the FERC's fundamental objective of creating a seamless, national competitive marketplace for wholesale sales of electricity and adequate infrastructure to support that marketplace.⁷ In the meantime, however, the evolution of RTOs and the related development of market rules within RTOs are regulatory variables that will complicate energy project financings.

4. Development of Standard Interconnection Agreements in Various Markets

Another regulatory variable for the energy project-financing community relates to interconnection agreements. In October 2001, the FERC issued an advance notice of proposed rulemaking to develop a standard interconnection agreement, as well as standard interconnection procedures for transmission owners, that would be applicable to all public utilities that own, operate or control transmission facilities subject to FERC's jurisdiction under the Federal Power Act.⁸ Currently, there is no standard – or FERC pro forma – interconnection service agreement or interconnection procedures employed in the industry. Nevertheless, the FERC has approved several forms of interconnection agreements and has emphasized that transmission-owning public utilities must offer interconnection service as part of open-access transmission service.⁹

This initiative by the FERC may be welcome news for generators who have complained about the interconnection process. Generators have argued that it is difficult to obtain interconnection without also requesting transmission service and that they do not receive equivalent service to that received by the transmission provider's own generation. There have also been complaints of delays and uncertainty stemming from the lack of any binding commitments or firm deadlines in the transmissions providers' pro forma tariffs. In response to these and other complaints, the FERC is considering basing the standard interconnection agreement and procedures on the Standard Generator Interconnection Agreement and Generation Interconnection Procedure of the Electric Reliability Council of Texas (ERCOT).¹⁰

⁶ The problem caused by such balkanization is exacerbated by the FERC's lack of siting authority for interstate electric transmission. See M. Lewis, "Federal Siting Authority for Interstate Electric Transmission Lines: Transmission Capacity Cannot Grow If New Lines Cannot Be Built." *The Electricity Journal*, October, 2001

⁷ *Electricity Market Design and Structure*, 97 F.E.R.C. (CCH) ¶ 61,146 (2001).

⁸ *Standardizing Generator Interconnection Agreements and Procedures – Advance Notice of Proposed Rulemaking*, 97 F.E.R.C. (CCH) FERC ¶ 61,099 (2001).

⁹ See Foster Electric Report, *FERC Unveils Two-Step Plan for Standardizing Generation Interconnection Procedures and Related Cost Allocations*, 2001 WL 10251862 (October 17, 2001).

¹⁰ *Id.*

5. Environmental Regulatory Developments

Recent developments involving environmental tax credits and regulations have created uncertainty for certain types of renewable energy projects. Chief among these developments is the expiration – as of December 31 of last year – of the production tax credit for wind-powered energy installations. Created as part of the Energy Policy Act of 1992¹¹, this 1.5-cents-per-kilowatt-hour credit for electricity produced by wind and other renewables has enabled many wind-powered facilities to produce electricity at more competitive prices. However, with the expiration of the credit last year, construction plans for many new wind-power projects have been postponed. Fortunately, legislation has been introduced in the current session of Congress to reauthorize the wind-power production tax credit for various periods, ranging from one year to five years to a permanent authorization. The Bush Administration has also signaled its support for tax credits for renewable fuels. While the prospects for a renewed wind-power tax credit seem promising, it is impossible to predict what will emerge from the current Congress. This lack of certainty will make it more difficult to close project financings of wind-powered energy projects in the near term.

6. New Source Review

Another area of regulatory volatility for energy project financings is new-source review reform by the EPA. It had been widely expected that the Bush Administration would propose a series of Clean Air Act reforms to EPA's New Source Review permitting program as part of a broader air quality initiative to reduce emissions from generation plants. However, President Bush announced that the New Source Review reforms had been put on hold until greater consensus emerged.¹² Nevertheless, on February 14 of this year, the Administration proposed legislation to reduce NO_x, SO₂, and mercury from power plants and announced its strategy for addressing global climate change.¹³ The three-pollutant legislation, called the "Clear Skies Initiative", would use cap-and-trade programs to achieve approximately 70 percent reductions for each of the three pollutants. In addition, the Administration's global climate change proposal commits to a strategy to achieve an 18 percent reduction in U.S. greenhouse gas intensity – in other words, the ratio of greenhouse gas emissions to economic output – over the next ten years.

With the debate over multi-pollutant legislation already raging in the Senate, it is unclear whether the Administration's proposal will be successful. Multi-pollutant legislation seems unlikely to pass in this Congress, but such legislation remains a possibility in future Congresses. The implications of such legislation on the siting of new generation capacity are significant. However, at this time, the precise details of such implications are quite uncertain and depend on

¹¹ Pub. L. No. 102-486, §§ 801-03, 106 Stat. 2921 (1992).

¹² InsideEPA.com, *White House Puts New Source Review Reforms On "Indefinite Hold,"* Vol. 23, No. 7 (February 15, 2002).

¹³ See http://www.epa.gov/epahome/headline2_021402.htm; see also <http://www.whitehouse.gov/news/releases/2002/02/20020214-5.html>.

the pollution reductions required by the legislation and whether reductions of carbon dioxide are included as well.

7. Comprehensive Energy Legislation

In early December of last year, Senator Jeff Bingaman, Chairman of the Senate Committee on Energy and Natural Resources, introduced comprehensive energy legislation entitled the Energy Policy Act of 2002. On February 15 of this year, the Senate Majority Leader Tom Daschle, who cosponsored the Bingaman bill, reintroduced the Energy Policy Act as an amendment to legislation authorizing funding for the Department of Energy. Senator Daschle's version of the legislation incorporates some increases in the fuel economy standard. As introduced, Senator Daschle's version of the legislation contains a provision (§ 265) that sets forth a renewable portfolio standard. This section would require that retail electricity providers generate or obtain a minimum percentage of their electricity from eligible renewable resources. Pursuant to the bill, the required annual percentages will be set by the Secretary of Energy for 2003 and 2004, and would rise to 2.5 percent renewables in 2005, with a 0.5 percent increase per year until 2020. To add flexibility and reduce the cost of meeting the requirement, the bill would create a system of tradeable renewable energy credits that will be used to satisfy the renewable portfolio requirement. If enacted, this provision will spur the siting and development of additional renewable resources.

In introducing the Energy Policy as an amendment to pending legislation, Senator Daschle has cleared the way for the legislation to bypass the committee process and go directly to the Senate floor, where it will be intensely debated. Over 100 amendments to the legislation are expected, thus making the future of the renewable portfolio standard somewhat uncertain.

8. Regulatory Accounting Requirements

Yet another area of regulatory uncertainty for energy projects is the potential for tighter accounting requirements for project-financed transactions. Currently, a primary difference between project finance and traditional corporate finance is that the former represents either limited recourse or non-recourse "off-balance sheet" financing.¹⁴ The "off balance sheet" nature of project financings enables a company using project finance to access far more capital than it could utilizing traditional corporate finance without adversely affecting its general credit rating.¹⁵ However, the future "off balance sheet" nature of certain project financings may be at risk.

Earlier this month, the Corporate and Auditing Accountability, Responsibility, and Transparency Act was introduced before the House Financial Services Committee. This legislation would create a new regulatory oversight body for the accounting profession and tighten disclosure requirements for public companies and their directors. Increased disclosure of off-balance-sheet transactions would be required in periodic reports and registration statements

¹⁴ David Blumental, *Sources Of Funds And Risk Management For International Energy Projects*, 16 Berkeley J. Int'l L. 267, *270 (1998).

¹⁵ *Id.*

of public companies. Under the bill, transactions and relationships would have to be disclosed if they are “reasonably likely to materially affect the issuer’s liquidity or capital resources, or otherwise expose the issuer to material current or possible future liability, obligations, expenses or changes in cash flow, or affect revenue recognition, carrying value, credit ratings, earnings, stock price, or cash flows or potentially impair assets.”

The SEC is also considering how to respond to the perceived flaws in our accounting system in the wake of the Enron bankruptcy. In several recent speeches addressing the Enron collapse, Harvey Pitt has emphasized the need to rethink accounting rules and to oversee the accounting profession. He plans to seek new accounting rules emphasizing “broad principles” instead of “narrow interpretations” as well new requirements for public companies to implement a current – or real-time – disclosure system. In project financings where sponsor support is extended directly or indirectly to project lenders through contingent equity, note purchase agreements, take-or-pay power marketing agreements, fixed or spark-spread based natural gas supply agreements, or more complex derivative arrangements, the application of such "broad principles" may result in a more searching analysis of the availability of off-balance-sheet financing treatment for some or all of project debt.

9. Conclusion

In conclusion, we are in a period of regulatory volatility that will challenge the energy project finance industry. The multiple advantages of project finance – such as the ability of credit-constrained project sponsors to finance capital intensive projects such as power plants utilizing the risk allocation techniques of project finance – will assure the ultimate success of project finance as a principal financing technique in the energy industry. In the meantime, however, a variety of regulatory and business challenges must be understood and addressed.